

# **California's Budget Conflict:** *Lessons from the Present and the Past*



**Daniel J.B. Mitchell**  
*Ho-Su Wu Professor*  
*Anderson Great Ideas*  
*Seminar*  
*April 14, 2004*

# **California's Budget Conflict:** *Lessons from the Present and the Past*



**Daniel J.B. Mitchell**  
*Ho-Su Wu Professor*  
*Anderson Great Ideas*  
*Seminar*  
*April 14, 2004*

# Note: *A Work in Progress*



Comments and  
suggestions welcome



# John Vasconcellos

## Dem. Senator - San Jose



*“I have never been so frightened  
about California’s future as I am  
now. The ingredients seem to be  
here to take the state right over the  
cliff.”*

# Keith Richman Rep. Assemblyman - Northridge



*“Without bipartisan  
cooperation, we are headed for  
a fiscal train wreck.”*

*“When a State borrows money to construct some great and permanent improvement, and leaves future generations to pay the debt, she also leaves them the work itself, as some sort of compensation. The violation of principle consists in the PRESENT generation assuming to act for and to bind the next without their consent. But the case is still worse, when a State borrows money to defray the ordinary expenses of her civil administration; because she bequeaths a debt to posterity, without any means to pay it.”*



*Gov. Burnett*

**Peter Burnett**  
**1st Calif. Governor**

*“When I previously proposed to the Legislature that we should set something aside for unforeseen needs, some people said I was taking a defeatist attitude—that I should be thinking in terms of prosperity and not depression — but I am still of the opinion that it is no more defeatist for a State to provide for a possible rainy day than it is for an individual to do so. I am as optimistic as anyone about the economic future of our State, but I think it is elementary prudence to establish a rainy day fund.”*



**Earl Warren**  
**30th Calif. Governor**



**“Everybody is entitled  
to my opinion.”**

*Madonna*





# **How I got into Calif. budget business**

- **UCLA Anderson Forecast**
- **Econ 103**
- **Creation of School of Public Policy & Social Research**
- **PS 10B: California Policy Issues**
- **California Policy Options starts in 1997**
- **Public event for CPO with Werner Hirsch in 2001**

**2/12/01: Hirsch and Mitchell,  
LA Times, op ed:**

*“As California’s electricity crisis unfolded, there was much talk about using the state’s “surplus” to fend off high energy costs. ... There is one problem... In the current fiscal year ending June 30, California is running a deficit. And the budget proposals for next fiscal year similarly project a deficit.”*



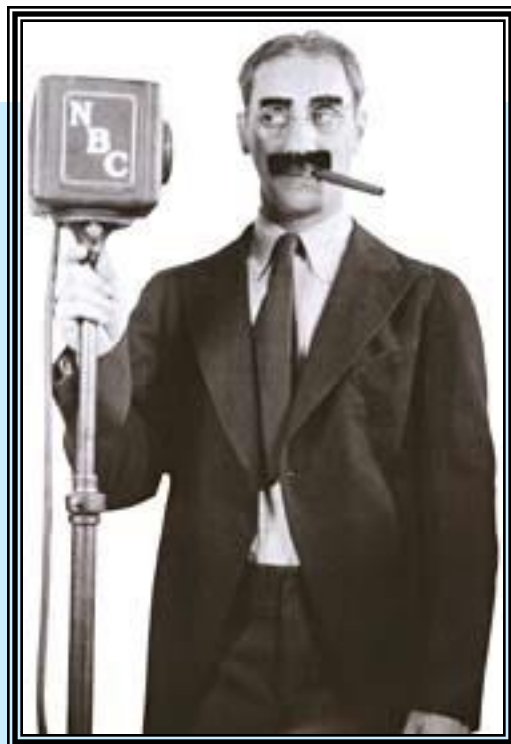
# 2/23/01: Tim Gage, State Director of Finance, LA Times, Letter to the Editor

*“The charge by (Hirsch and Mitchell) that California is running a deficit is flatly untrue.”*



***“Who are you gonna believe? Me or your own eyes?”***

**Groucho Marx**



# 12/18/02: Tim Gage, State Director of Finance, quoted in Gov. Davis' press release announcing Gage's replacement

*“I look forward to other opportunities that will allow me to spend more time with my family.”*



# California's Budget Conflict: *Lessons from the Present and the Past*

- **There is a BIG budget problem**
- **The conflict may not be where you think**
- **California's fiscal history provides some clues about the problem's location**
  - Taxpayer revolt
  - Transportation projects
  - Other public works & services
- **Implications**





Now Available

THE COMIC BOOK OF THE YEAR  
ARMAGEDDON







*What's the  
real story?*



*Short run vs.  
underlying*





# The Short Run



Where Have All the  
Dollars Gone?

## Where Have All The Flowers Gone?

## Calypso tempo

P. SEGER

[illegible]

Where have all the flowers gone, long time pas - sing?

Where

go? —

Where

every-one.

When

?





# Where Have All the Dollars Gone?







# Where Have All the Dollars Gone?





# Where Have All the Dollars Gone?





# Where Have All the Dollars Gone?





# Where Have All the Dollars Gone?





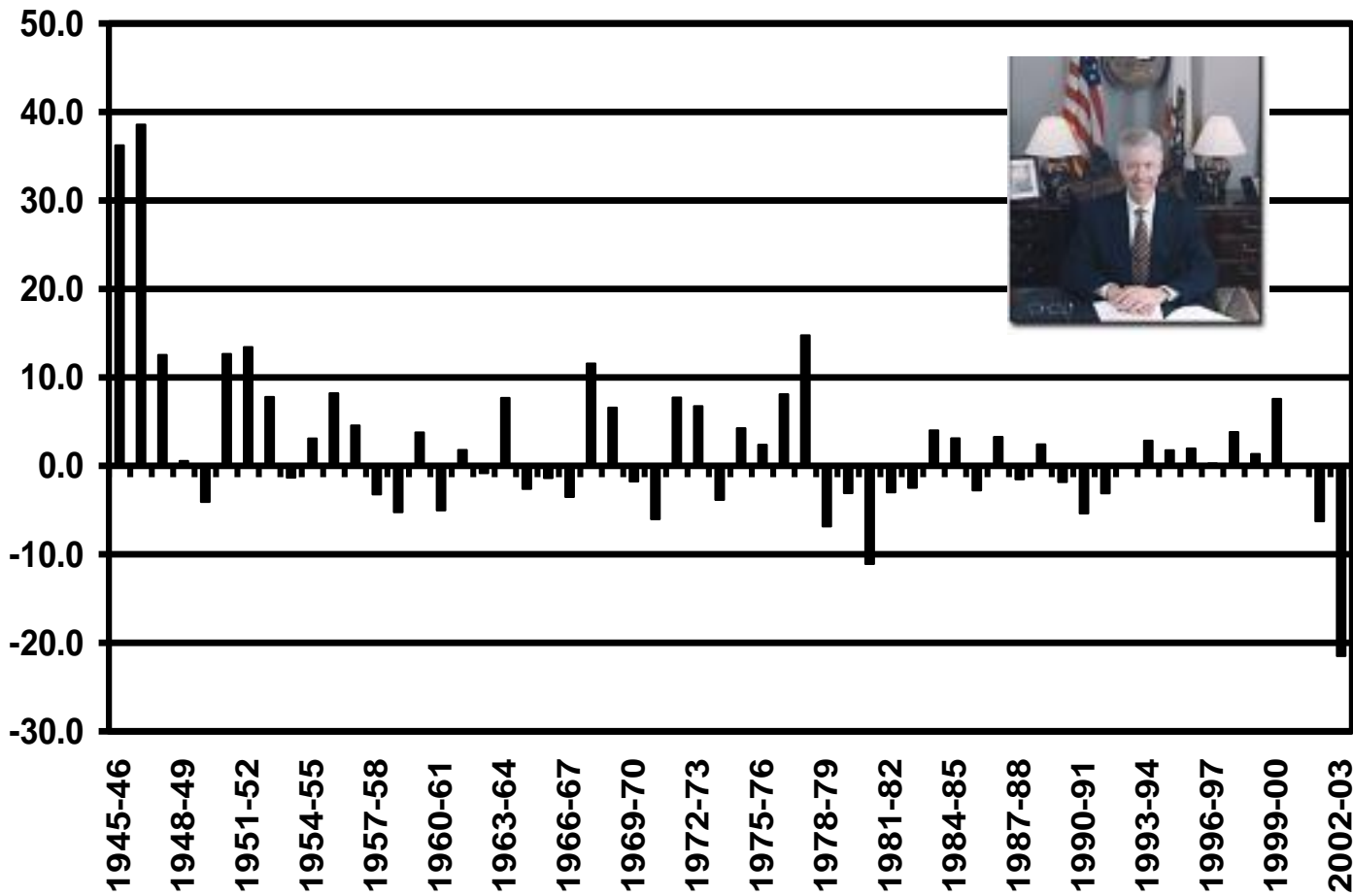


# Where Have All the Dollars Gone?



## General Fund Surplus or Deficit as Percent of Revenues & Transfers

CPObudget2004.xls  
Surplus%

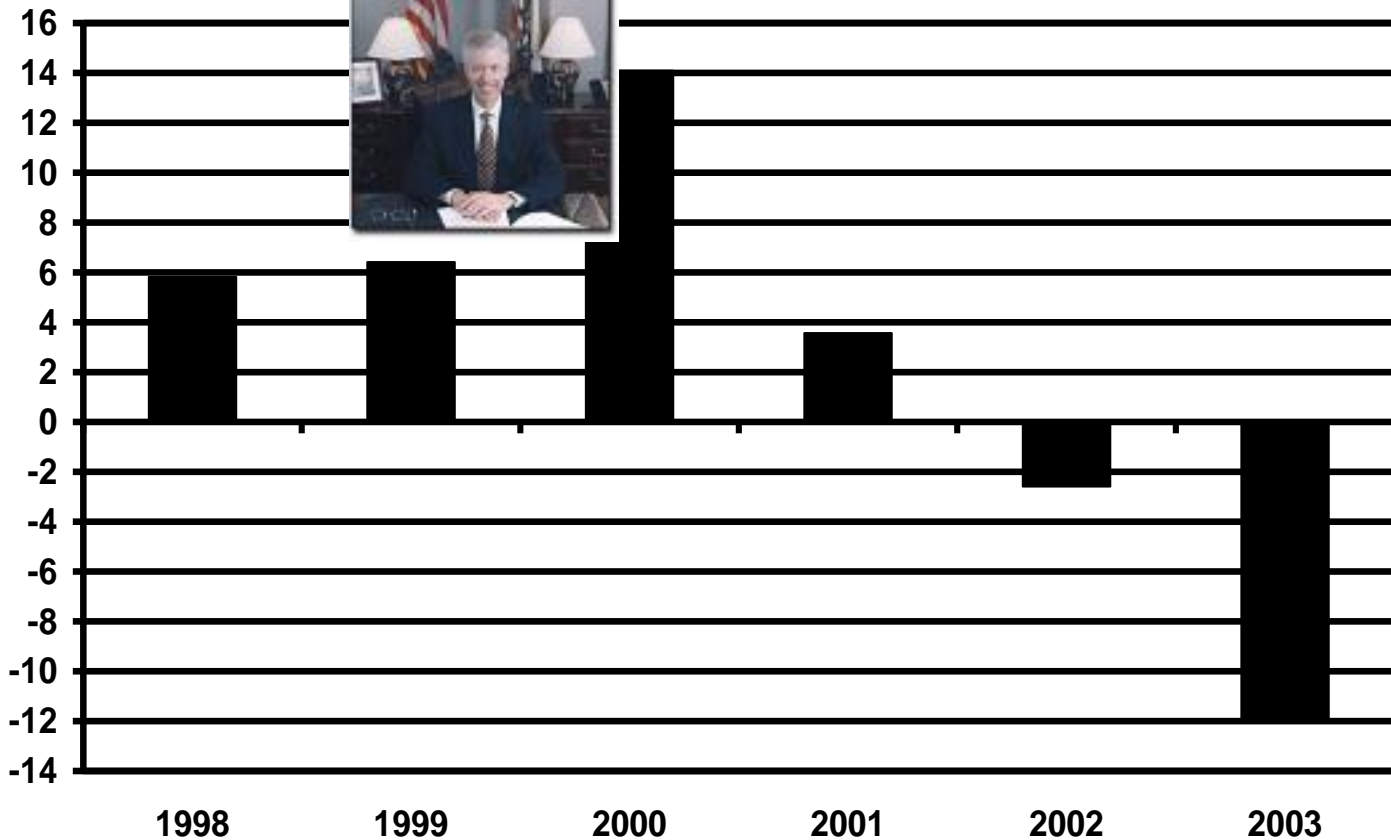


# What happened?

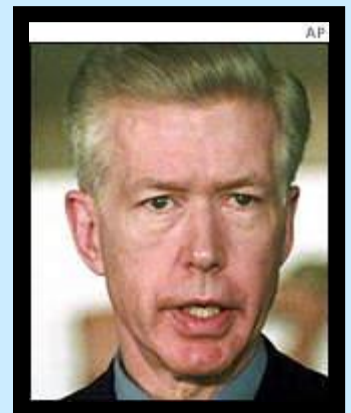


**Official Reserve as Percent of Expenditures: June 30 of Year Shown  
Excluding Proposed Deficit Finance for 2002-03**

CPObudget2004.xls  
offresrv



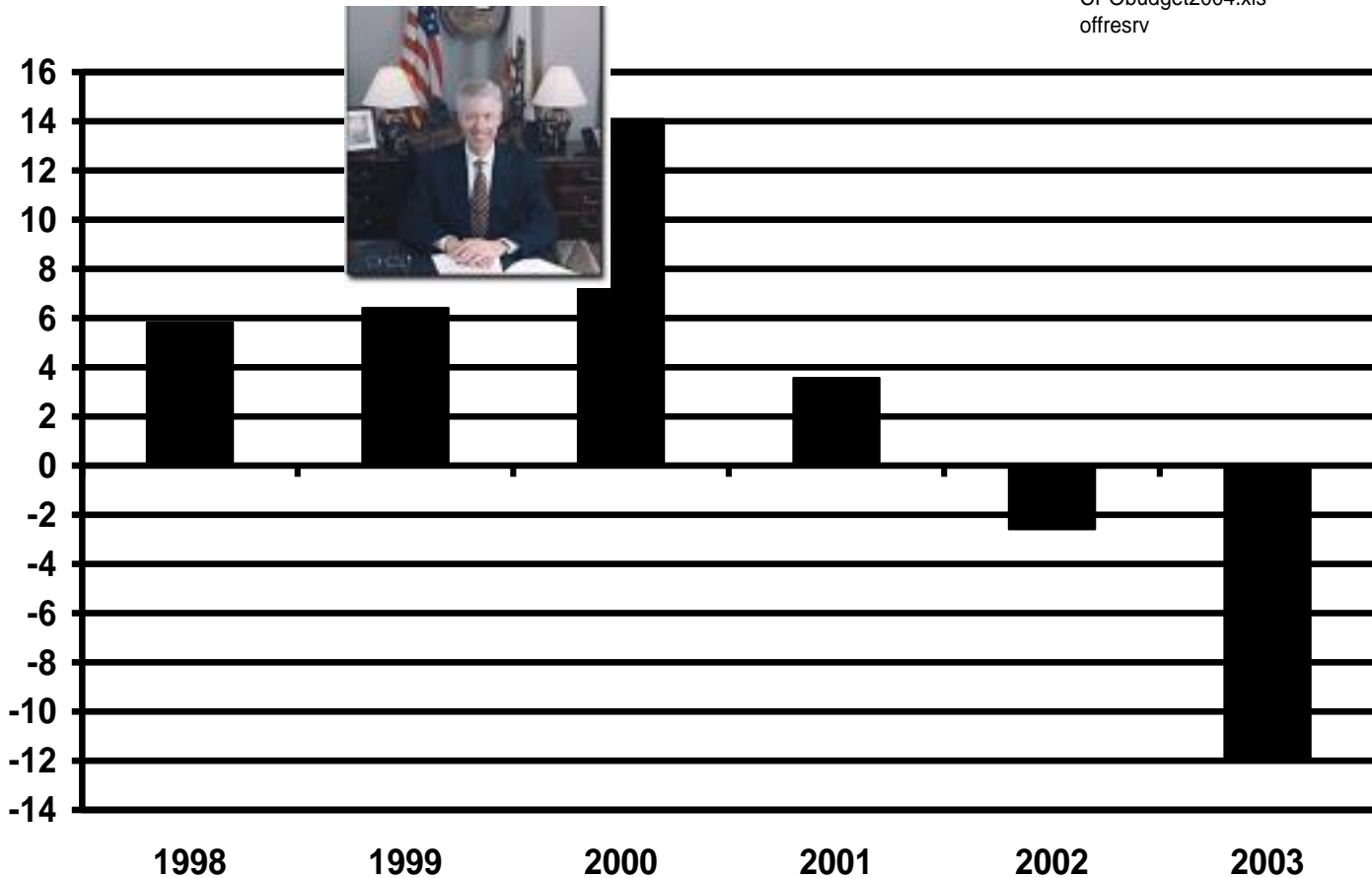
**What  
happened?**





**Official Reserve as Percent of Expenditures: June 30 of Year Shown  
Excluding Proposed Deficit Finance for 2002-03**

CPObudget2004.xls  
offresrv



**What  
happened  
Hiram?**



TALES  
OF THE OVERLY  
OPTIMISTIC..



I THINK I CAN  
I THINK I CAN  
I THINK I CAN  
I THINK I CAN  
I THINK I CAN...

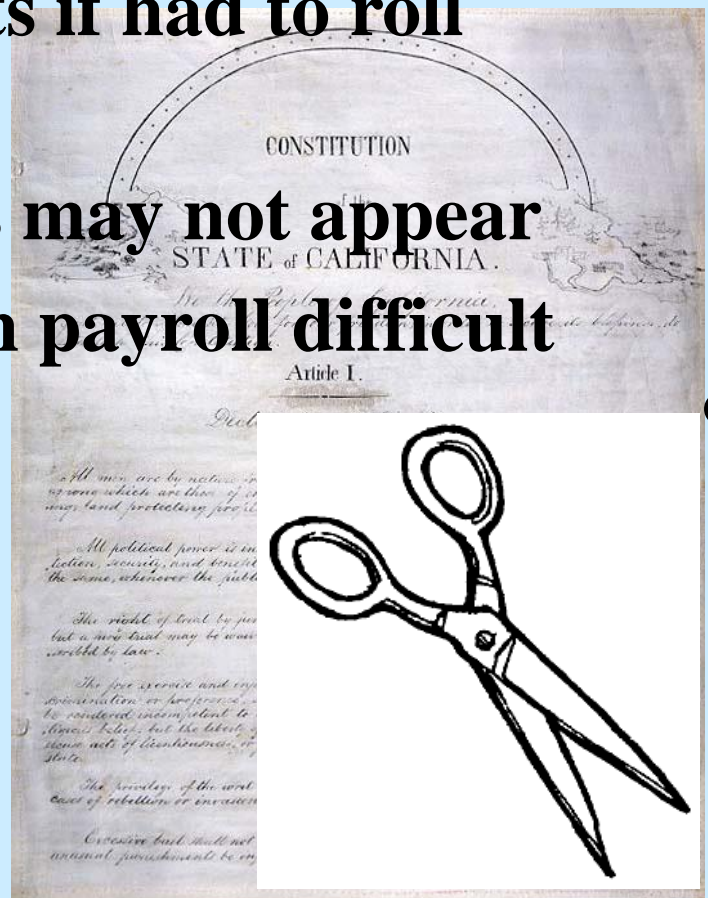


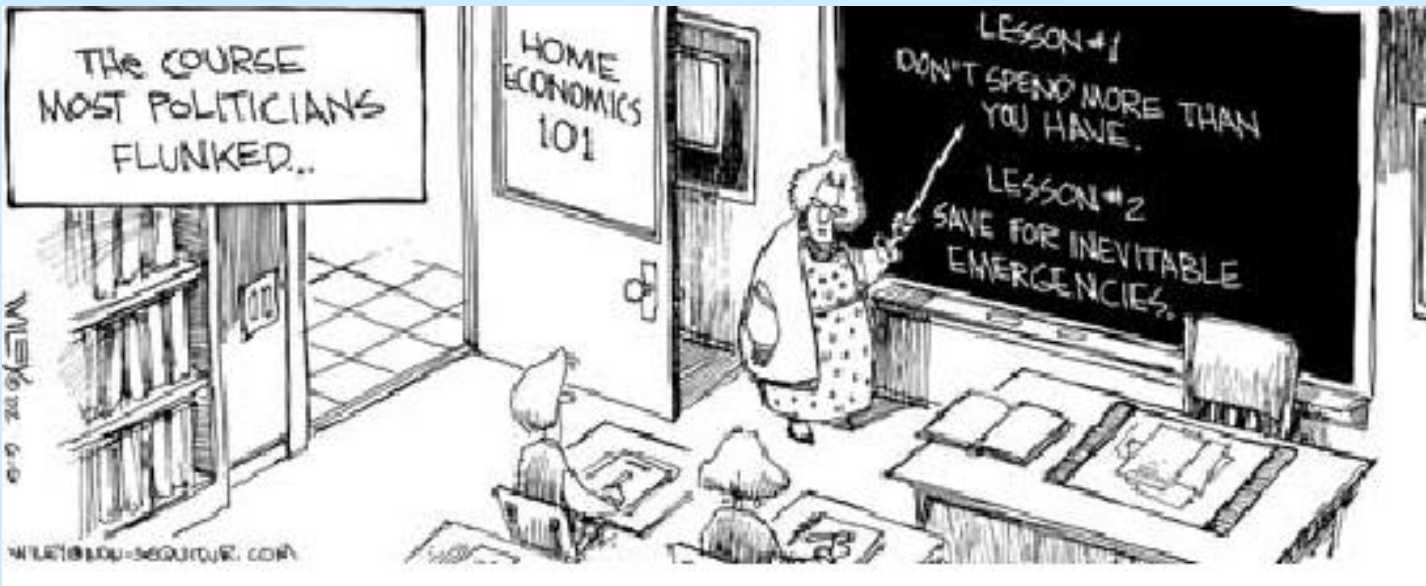
VIEW

# ***Risks in the “Davis” budget***



- Deficit financing proposed was probably illegal (\$2 + \$10.7 billion)
- RAWs & RANs mature in June 2004; high costs if had to roll over
- Some revenues may not appear
- Planned cuts in payroll difficult to achieve





**Why does California  
feel exempt?**

# If California were a country, it would be the...

- 5th
- 6th
- whatever

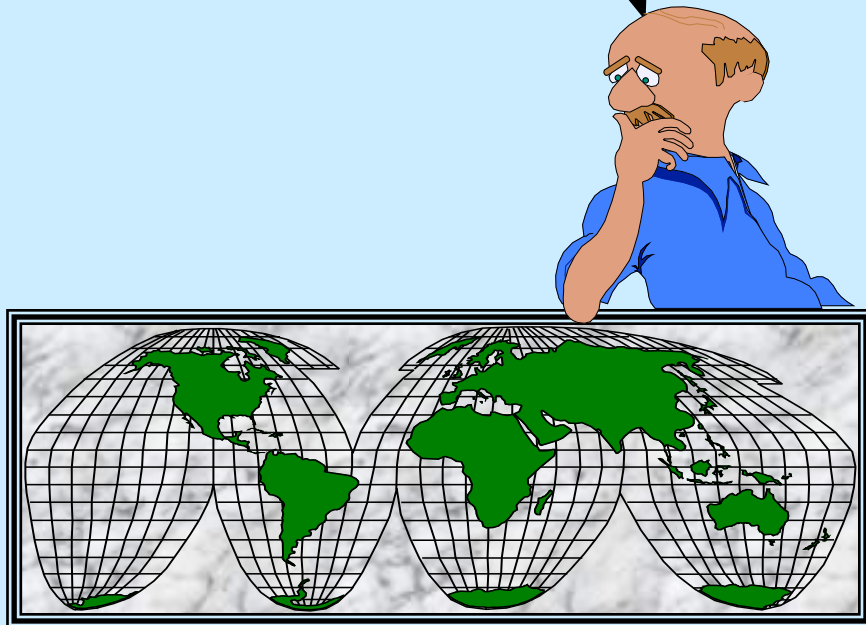


largest country in the world depending on the year chosen.

## What does this statement mean?

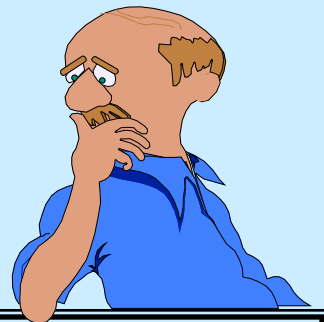
•

**What  
makes a  
country?**





# Having a government?



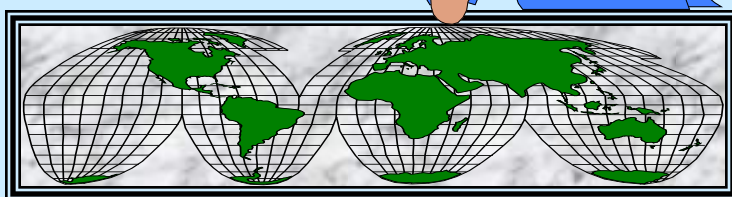
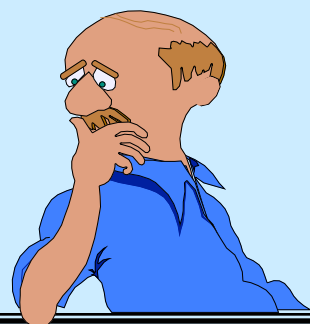


# Belonging to the UN?

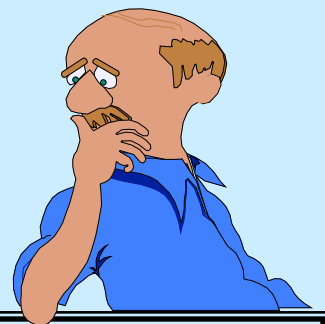


**Switzerland?**

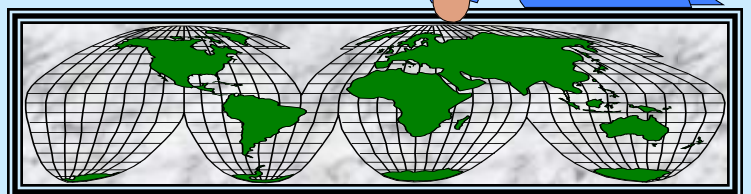
**Taiwan?**



# Having a post office and issuing stamps?



UN?



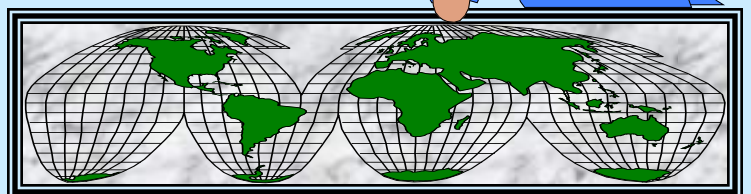
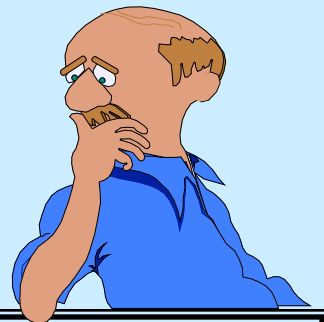
# Speaking a common language?



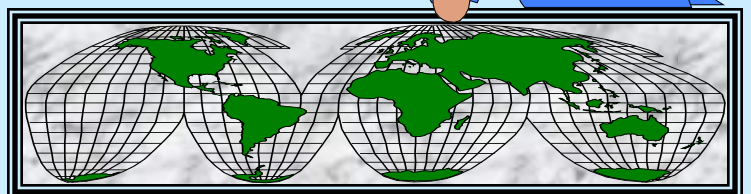
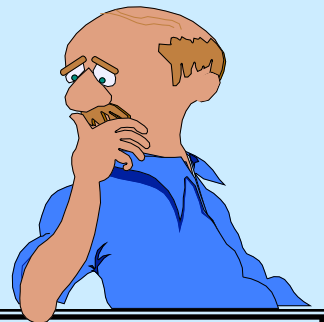
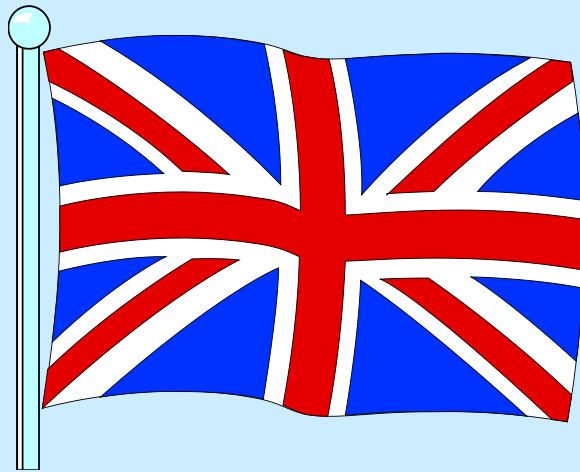
*The Tower of Babel*  
*by Pieter Bruegel (c. 1525-69)*

**Belgium?**

**India?**



# Having a flag?

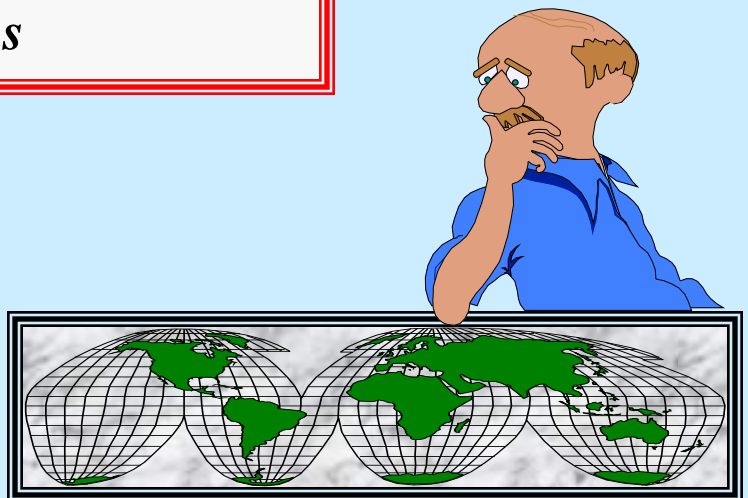


# Sovereignty?

**“I am the master of  
my fate;  
I am the captain of  
my soul.”**

**William Ernest Henley**

*Invictus*

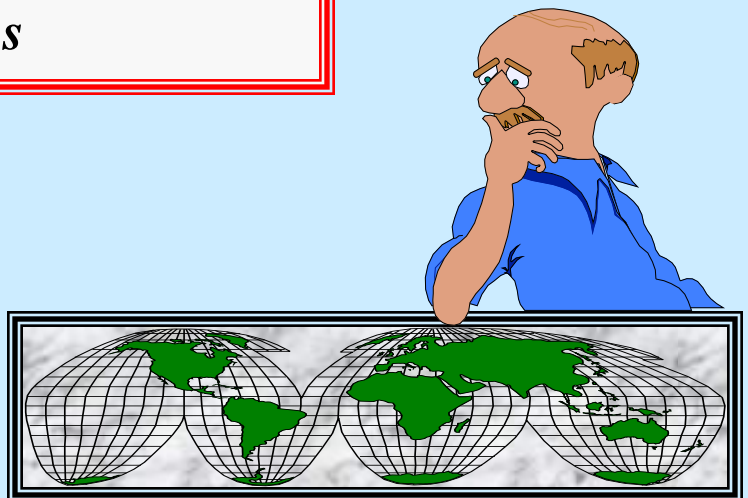


# Fiscal Sovereignty?

**“I am the master of  
my fate;  
I am the captain of  
my soul.”**

**William Ernest Henley**

*Invictus*





# *California has no Alan Greenspan*

- **There is no  
California  
currency**



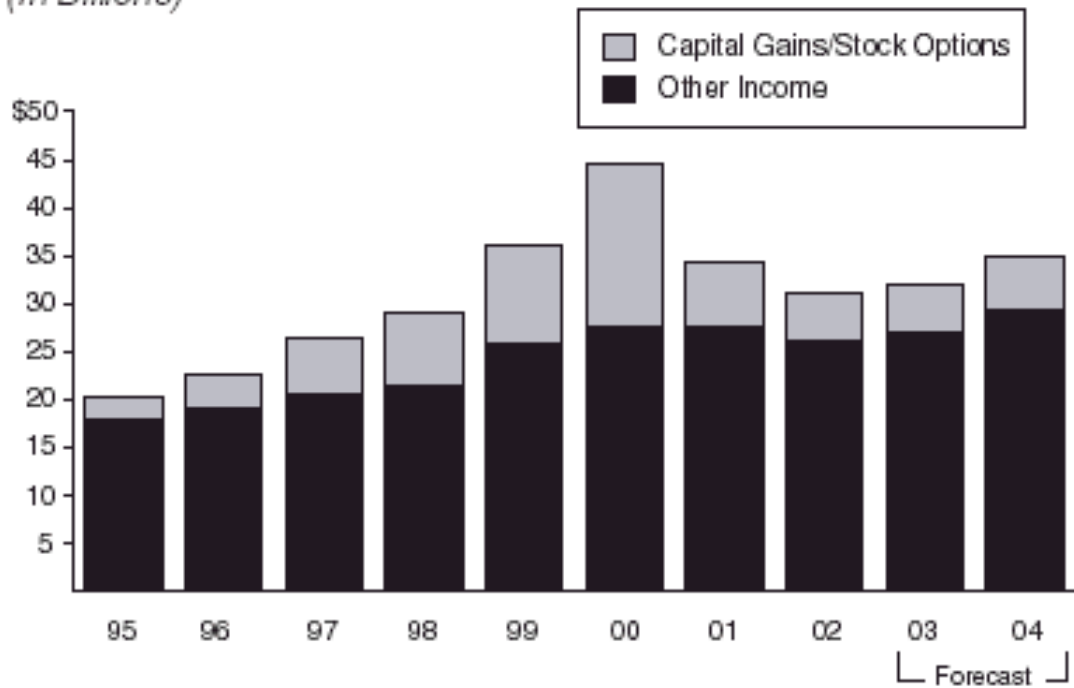
- **Its govt.  
can't run big  
deficits for  
long periods**



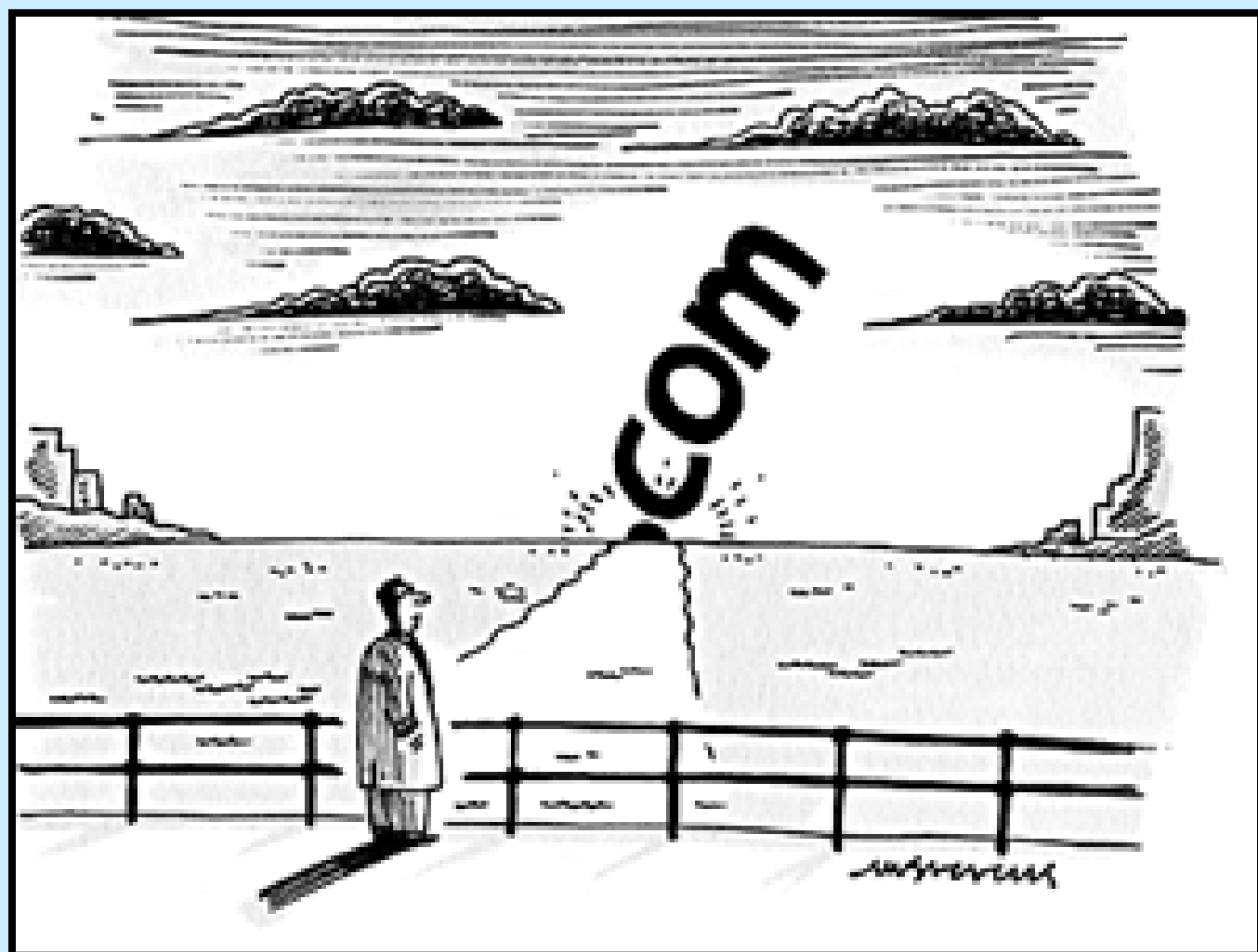
Figure 6

## After Plunging, PIT Liabilities to Grow Moderately

*California Annual PIT Liabilities, by Source  
(In Billions)*



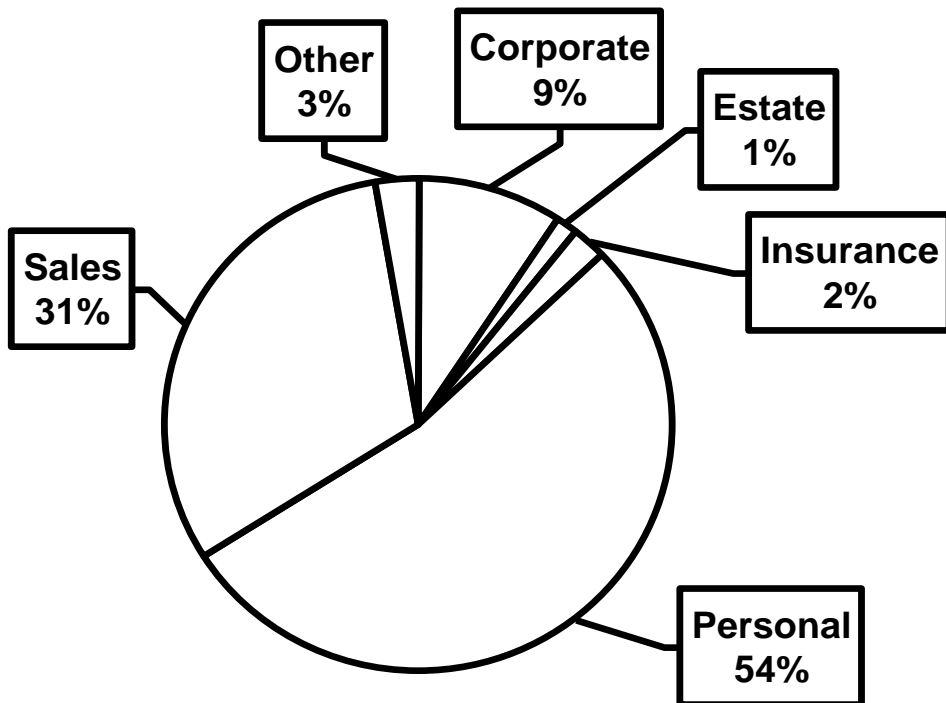
**In FY 2000-01, personal income taxes produced \$17 billion in revenue from capital gains (22% of general fund revenue).**



# *Budget Structure*

## General Fund Revenue Sources: 1997-98 - 2002-03

calborrow.xls  
source%

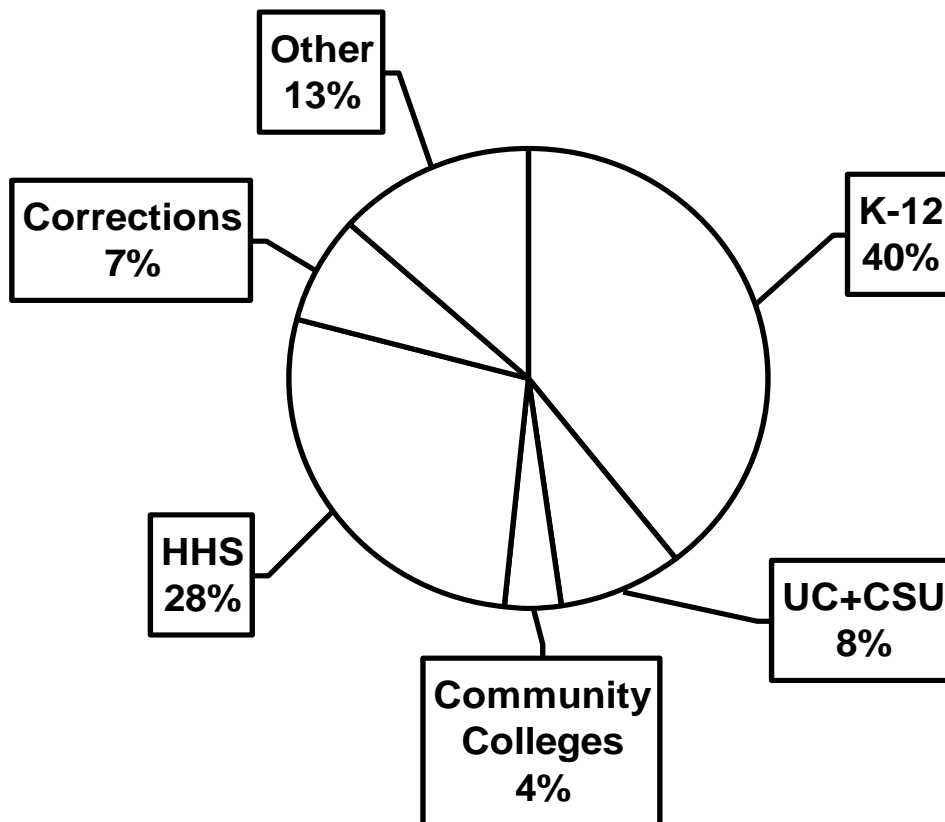


**Note: Excludes tobacco bond revenue in 2002-03.**

# *Budget Structure*

**General Fund Expenditure Categories: 1997-98 - 2002-03**

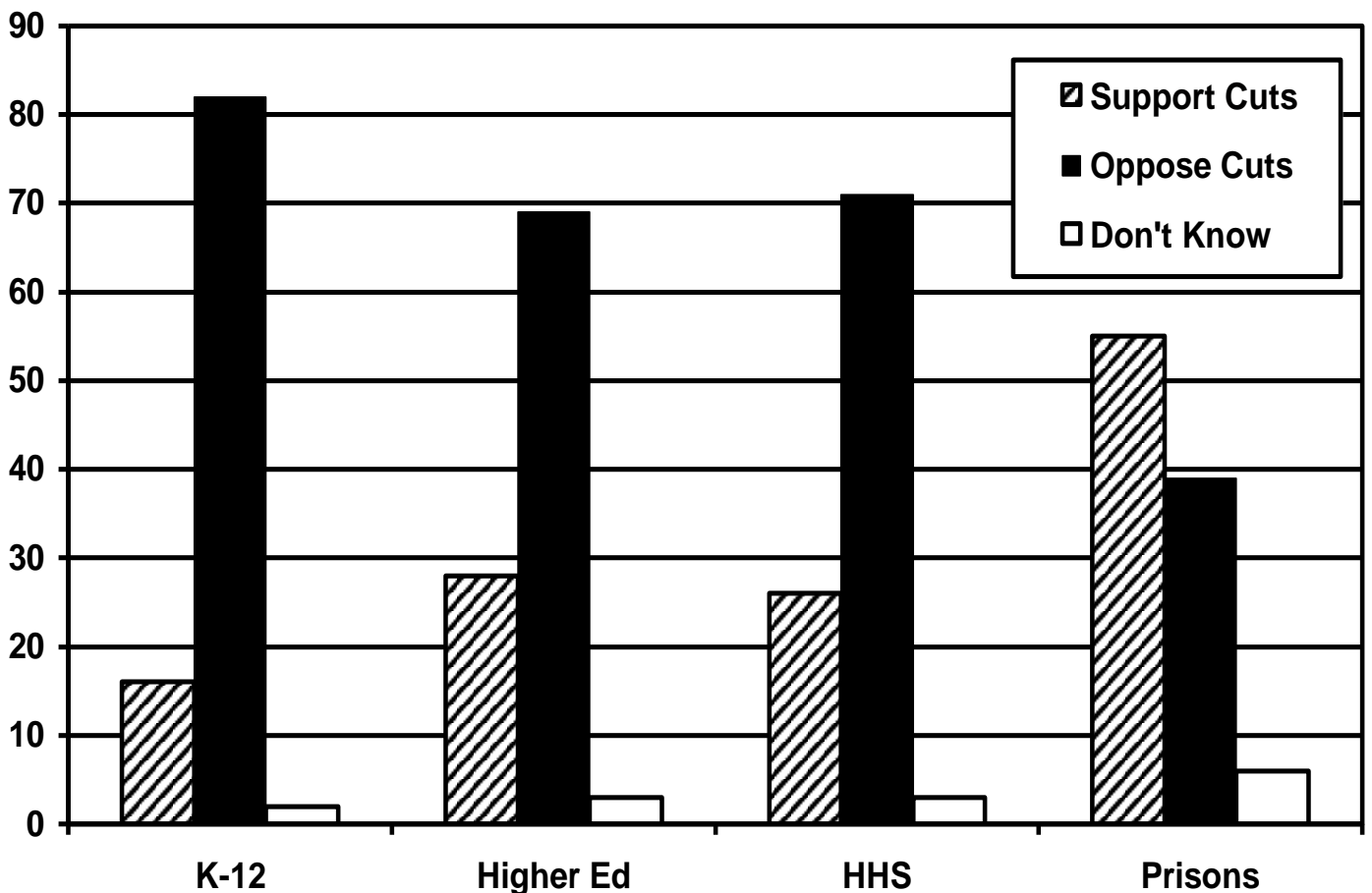
CPObudget2004.xls  
spend%



# Public Opinion (PPIC)

Opinions of Adult Californians Regarding  
Possible Spending Cuts (Percent)

calopinion.xls  
spendcut

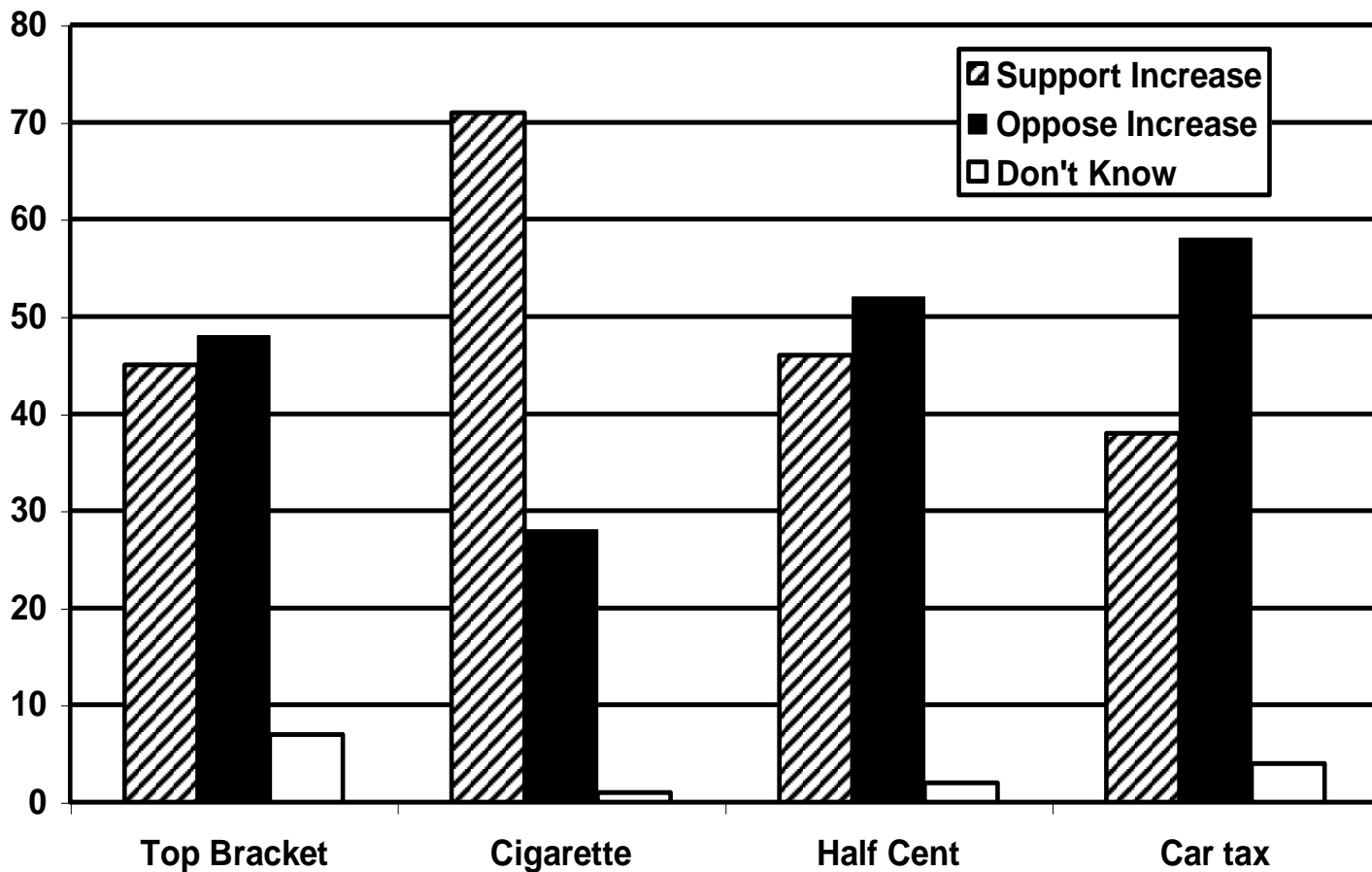




# Public Opinion (PPIC)

Opinions of Adult California Regarding  
Potential Tax Increases (Percent)

calopinion.xls  
taxup



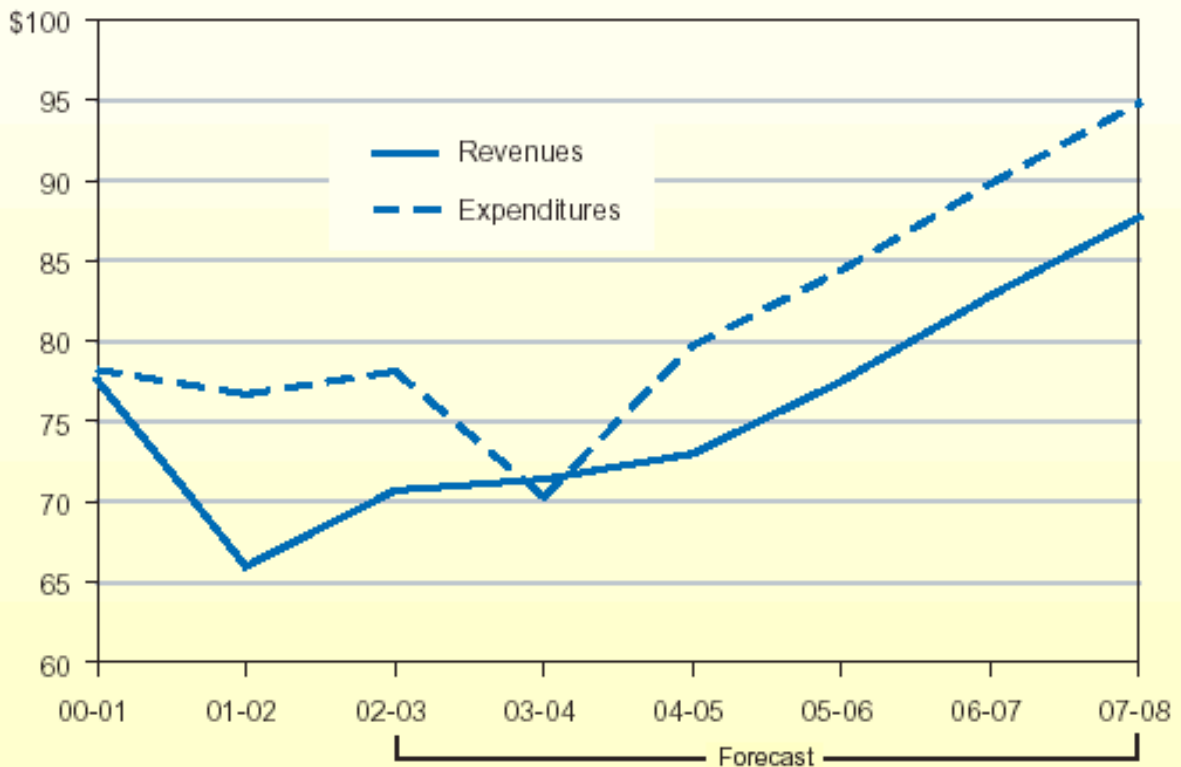
**NOTE!**

# Structural Deficit Estimated by LAO under Davis

Figure 7

**Persistent Gap Would Reemerge Under Governor's Plan**

*General Fund  
(In Billions)*

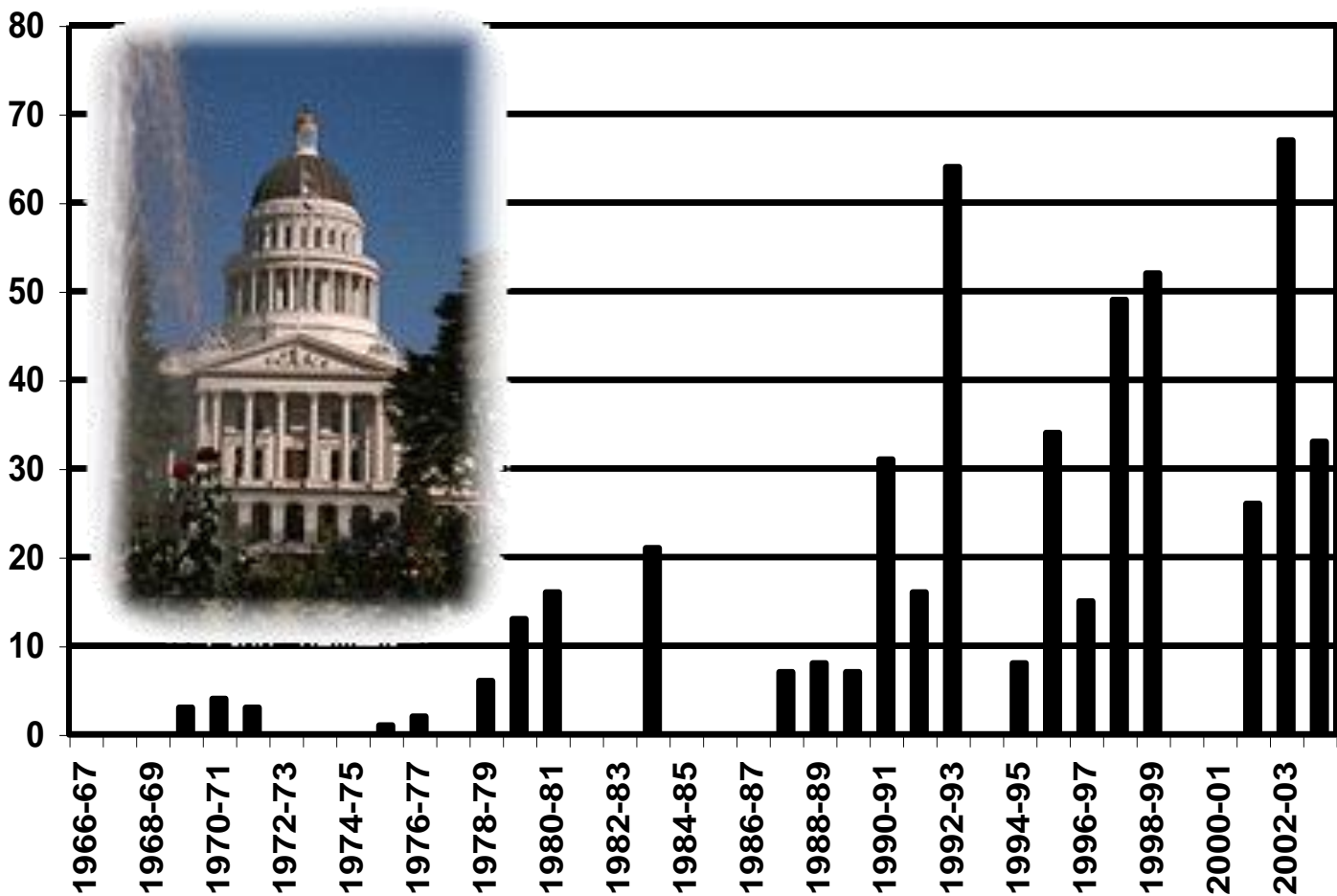


**Rand said same thing  
in mid-1990s!**

# *Legislative Gridlock?*

Days of Budget Delay Beyond June 30

CPObudget2004.xls  
DELAY2



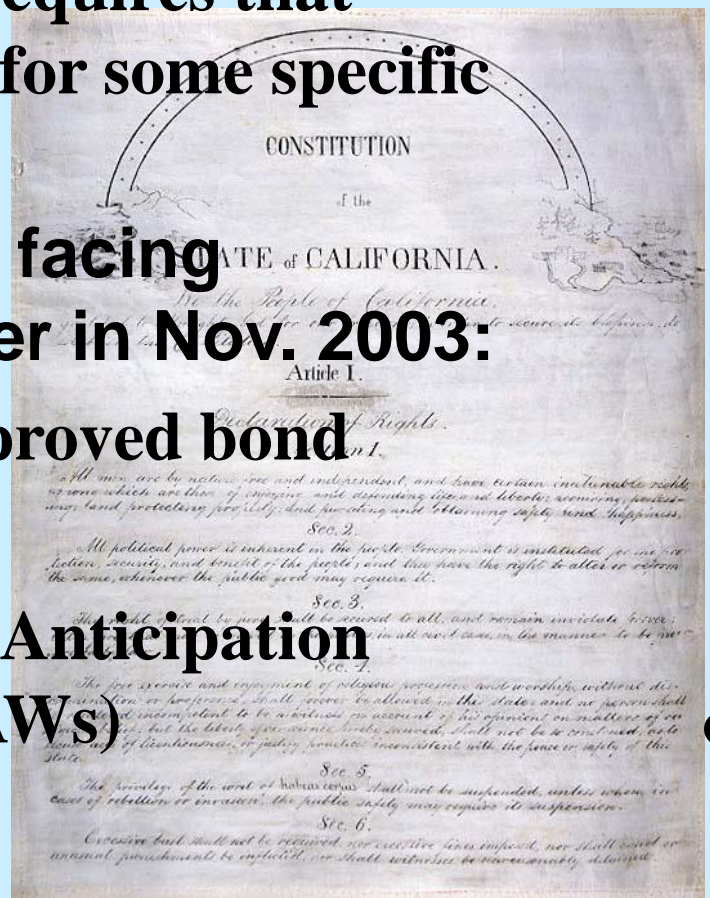
# *Groping for a Solution*

RAVENS  
© 1998 by the artist



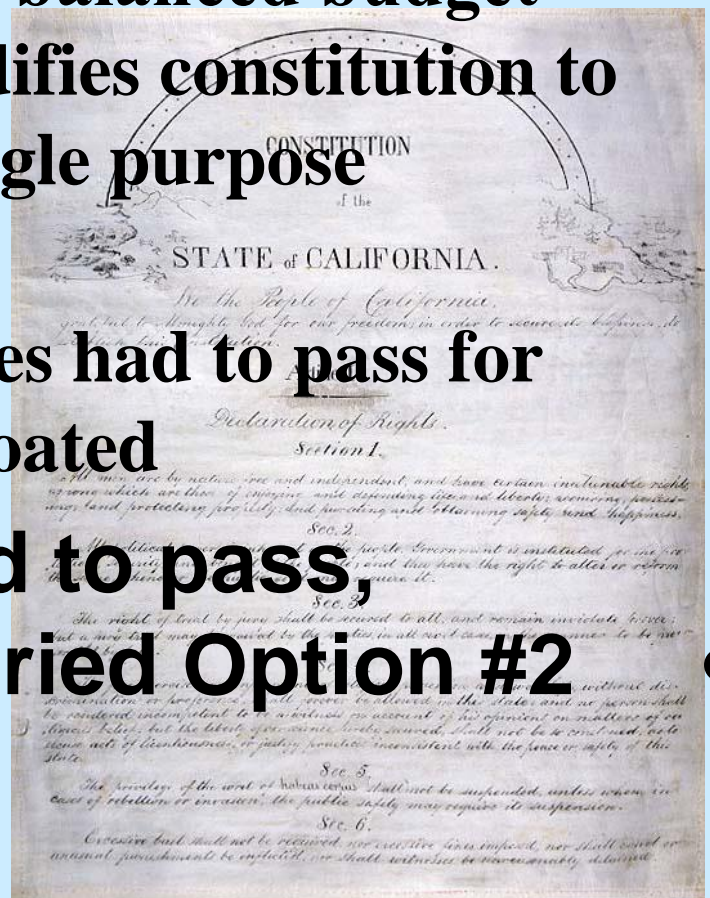
# temporary *Groping for a Solution*

- Deficit financing for another year plus refinancing of accumulated debt
  - Constitution requires vote on (long-term) obligations of general fund
  - Constitution requires that borrowing be for some specific purpose
- 3 Options were facing Schwarzenegger in Nov. 2003:
  - New voter approved bond
  - Davis bond
  - New Revenue Anticipation Warrants (RAWs)



# temporary *Groping for a Solution*

- **Option #1: Schwarzenegger \$15 billion bond on March 2004 ballot (Props 57 & 58)**
  - Ballot overcomes constitutional objection on need for vote
  - Companion “balanced budget” measure modifies constitution to overcome single purpose objection
  - Both measures had to pass for bond to be floated
- **If bond failed to pass, might have tried Option #2**





# temporary *Groping for a Solution*

- **Option #2: Davis \$10.7 billion bond**
  - Annual vote of Legislature required to pay debt service (to avoid having the bond be considered “long term”)
  - Complicated “triple flip” adopted by Legislature to make bond not an obligation of the general fund



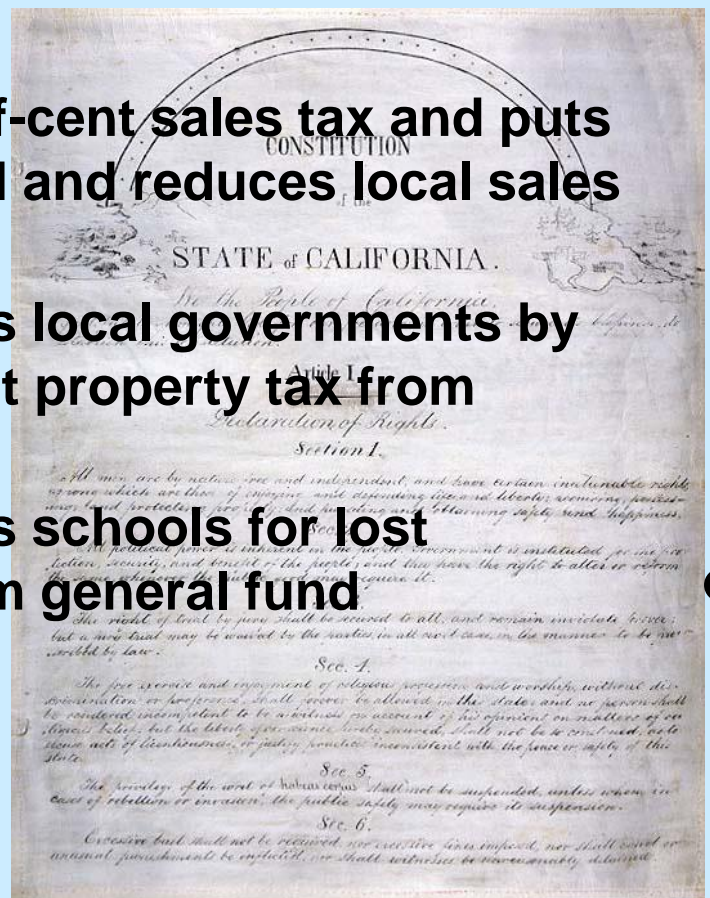
# temporary *Groping for a Solution*



- **Options**
  - **Are**
  - to**
  - the**
  - **Can**
  - Le**
  - ob**



- **Triple flip:**
  - **State enacts half-cent sales tax and puts into special fund and reduces local sales tax by half cent**
  - **State reimburses local governments by taking equivalent property tax from schools**
  - **State reimburses schools for lost property tax from general fund**



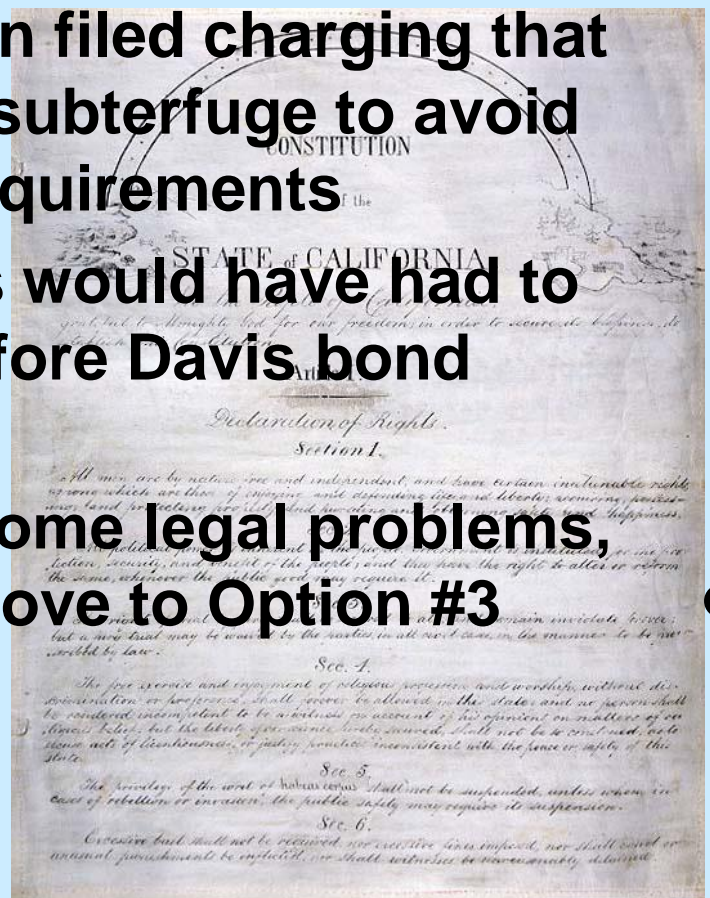
# temporary *Groping for a Solution*



- **Options**
  - **Arrest**
  - **to**
  - **the**
  - **Co**
  - **Le**
  - **ob**



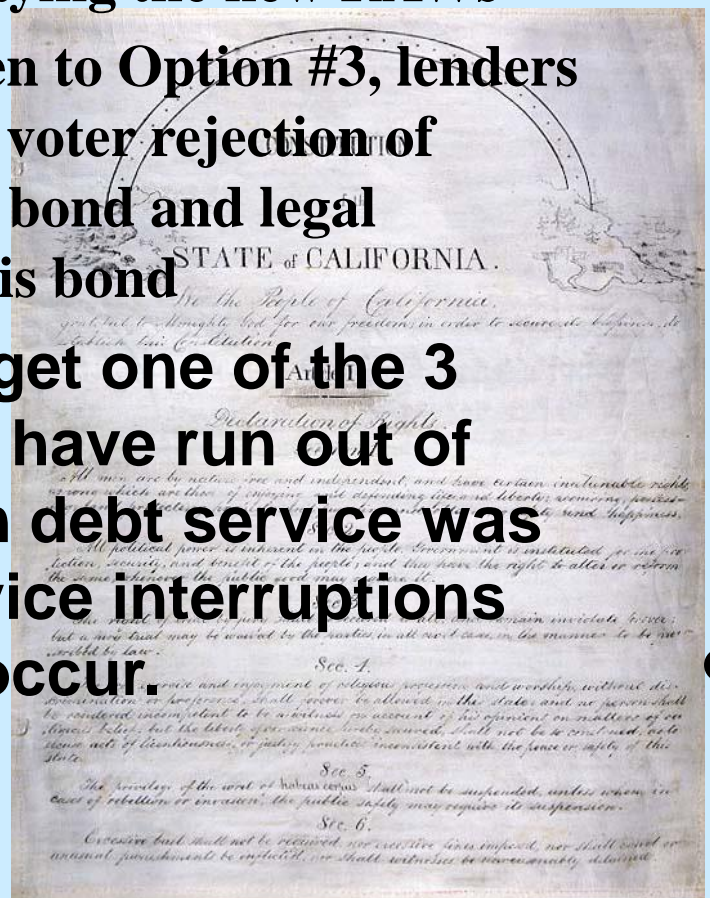
- **Lawsuit had been filed charging that Davis bond is a subterfuge to avoid constitutional requirements**
- **Legal objections would have had to be overcome before Davis bond could be sold**
- **If couldn't overcome legal problems, would have to move to Option #3**



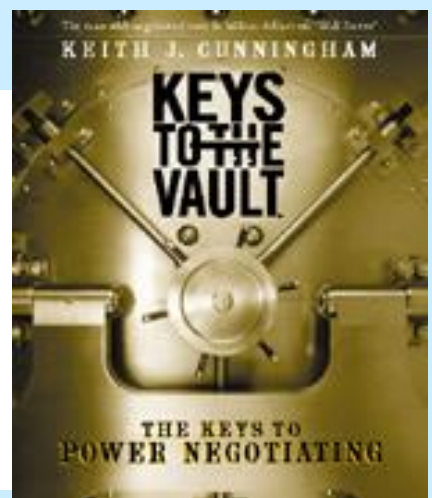
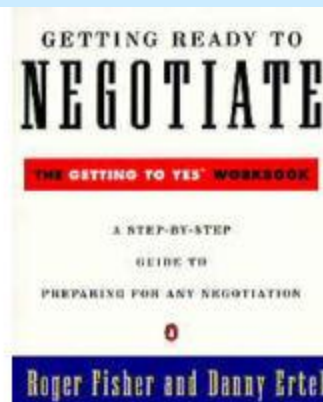
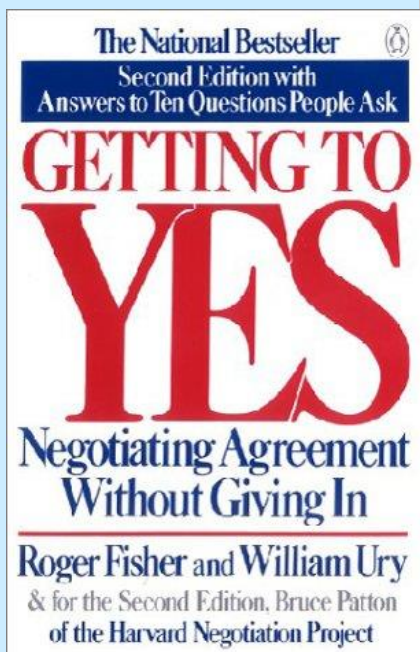
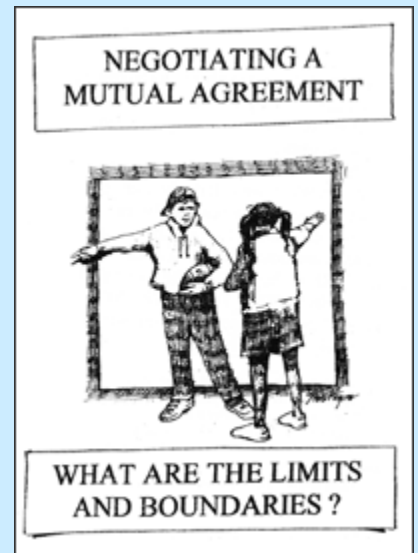
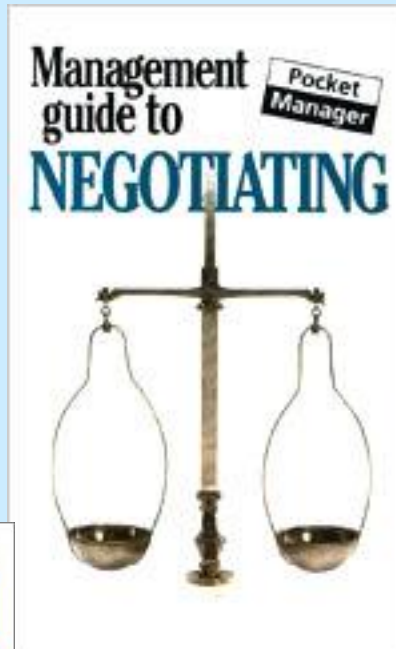
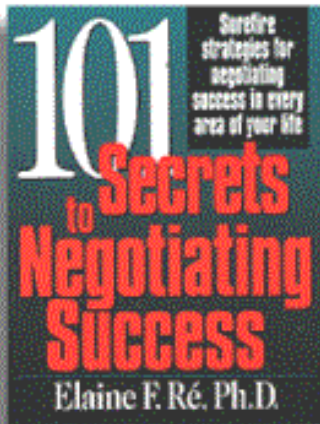


# temporary *Groping for a Solution*

- **Option #3:  
Revenue Anticipation Warrants**
  - State has \$11 billion in RAWs issued in June 2003 coming due + \$3 billion in Revenue Anticipation Notes (RANs)
  - Unless a budget were in place, potential lenders would not have had a plan to examine for repaying the new RAWs
  - If state had gotten to Option #3, lenders would have seen voter rejection of Schwarzenegger bond and legal challenge to Davis bond
- If state failed to get one of the 3 options, it could have run out of cash. Default on debt service was unlikely but service interruptions would be likely occur.



# *Generic Negotiation Approach?*



# *Generic Negotiation Approach?*



Management  
guide to  
**NEGOTIATING**

Pocket  
Manager

NEGOTIATING A  
MUTUAL AGREEMENT



ARE THE LIMITS  
BOUNDARIES ?



The National Best  
Second Edition  
Answers to Ten Questions

**GETTING  
YES**

**Negotiating Agreement  
Without Giving In**

**Roger Fisher and William Ury**  
& for the Second Edition, Bruce Patton  
of the Harvard Negotiation Project

A STEP-BY-STEP  
GUIDE TO  
PREPARING FOR ANY NEGOTIATION

**Roger Fisher and Danny Ertel**





*Is the budget problem  
another version of a labor  
negotiation?*



# Who are the parties to the “negotiation”?

- **Legislature**
- **Governor**
- **Interest groups**
- **Electorate**



# Who are the parties to the “negotiation”?

Why can't  
we all just  
get along?

Rodney King



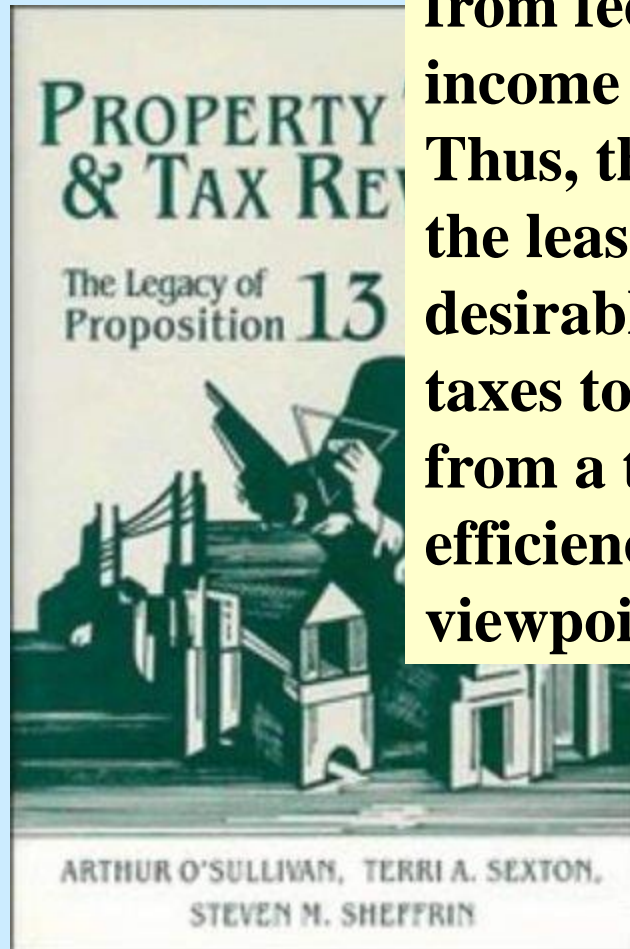
# **Howard Jarvis and Paul Gann celebrate**



**Passage of Prop 13  
(1978)**



## Numerous Studies



Note that both property and car taxes are deductible from federal income tax. Thus, they are the least desirable taxes to cut from a tax efficiency viewpoint.

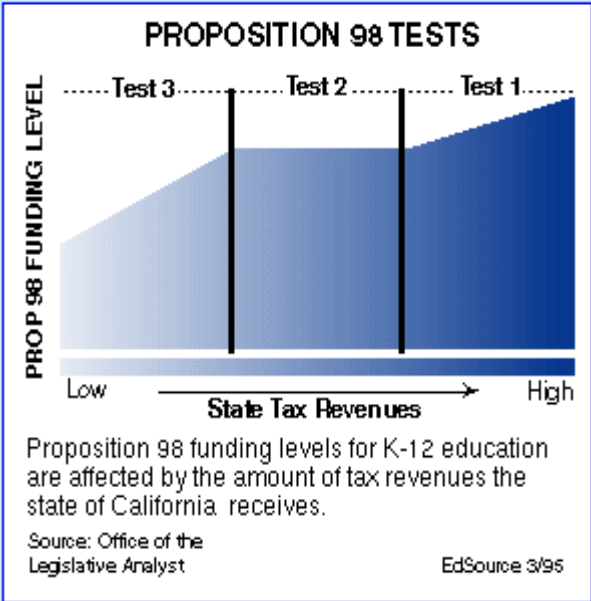
**Question:** Why was the *property tax* the focus of the taxpayer revolt?

**Related Question:** Why was the *car tax* such an issue in the recall?

*Inadvertent consequence*



**More dependence  
on Sacramento ==>  
more constraints  
on Sacramento**





# *Inadvertent consequence*



## **Fiscalization of land use**



**BOTTOM LINE  
QUESTION:**



***Why did we have a  
taxpayer revolt?***



## **BOTTOM LINE QUESTION:**



***Why do we still have a  
taxpayer revolt?***

# *Looking Outside the General Fund*



- Governor's proposed expenditures from GF for 2004-05 = \$80.3 billion (excluding funny math)
- Governor's proposed expenditure from special funds = \$21.1 billion
- Lesson: About one fifth of expenditures (excluding pensions) is outside the GF





# *Transportation*

- **Special funds to receive \$7.8 billion in motor-vehicle related taxes**
  - Fuel taxes
  - Registration, weight, license, etc.
- **Total expenditure for business-transportation-housing is to be \$5.5 billion (not all for transportation)**



# Prof. Jeffrey Brown



**Florida State University**  
***PhD Urban Planning 2003*** ●



# California State Archives



*Sacramento*



# Gov. Olsen dedicates Arroyo Seco Parkway



...later known as the  
Pasadena Freeway



# *Standard Federal Story*

- **Constitution: Post roads**
- **Alternatives**
  - Rivers and canals
  - Railroads
- **Mainly local roads and local responsibility**
- **Good Roads movement**
- **Automobiles arrive**
- **Federal role expands with Bureau of Public Roads**



# ***Standard Federal Story***

- **Constitution: Post roads**
- **Alternatives**
  - **Rivers and canals**
  - **Railroads**
- **Mainly local roads and responsibility**
- **Good Roads movement**
- **Automobiles arrive**
- **Federal role expands with Bureau of Public Roads**
- **Depression gas tax & public works**
- **“Toll Roads and Free Roads”  
report of 1939 (with funny math)**



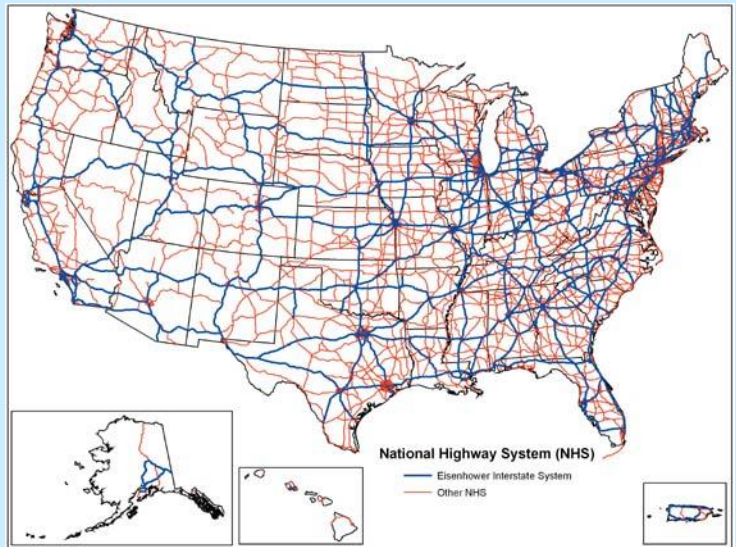


***“Germany ... made me see the wisdom  
of broader ribbons across the land.”***

**Dwight D. Eisenhower**



# 1956: Federal Interstate and Defense Highway System Legislation



**Federal-Aid Highway Act of 1956**



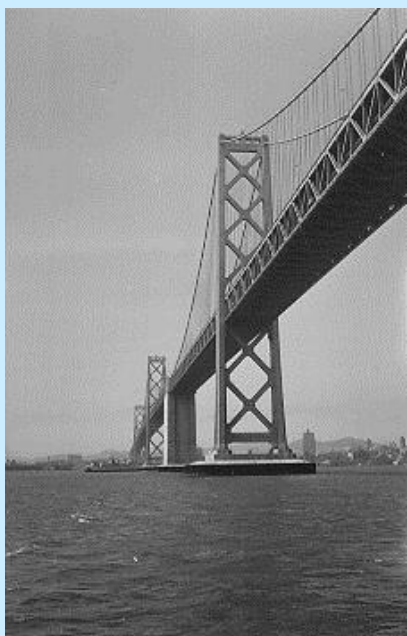
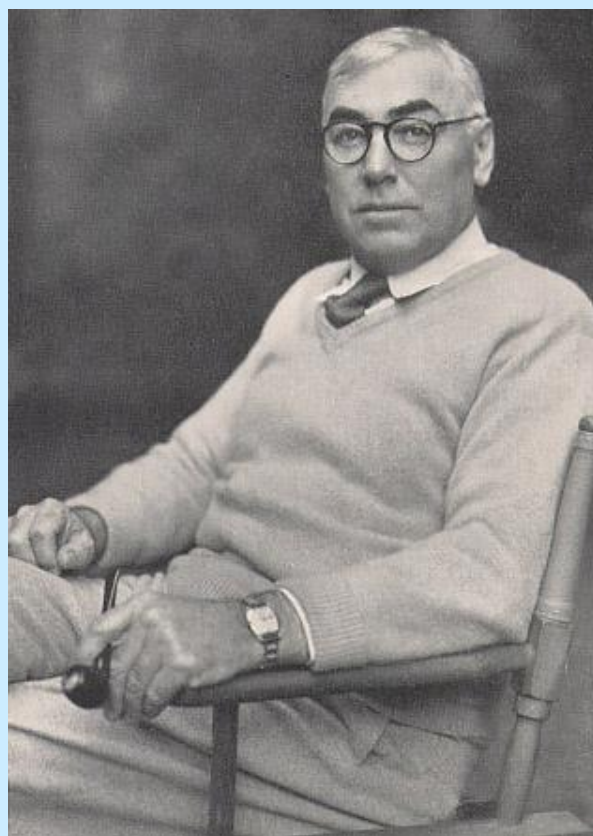
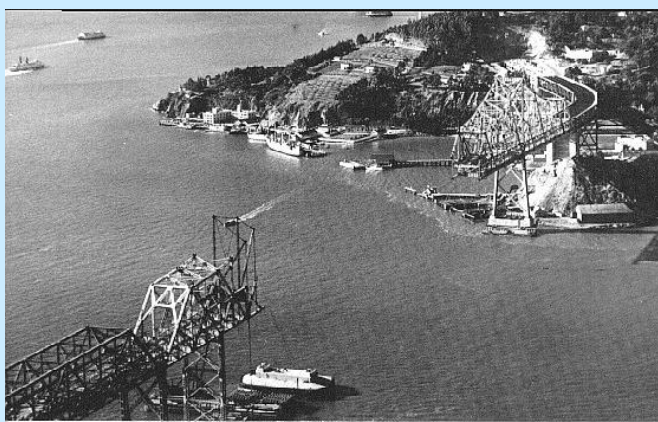
# *An Alternative California-centric Tale*



# *Earl Warren*



# *Charles H. Purcell*





# *1940s Legislature*

**“How are you today  
Mr. Legislature?”**



**Arthur H. Samish** ●

*Collier's*, August 1949

# *Building of Lakewood, California*



Annual rate of  
growth:

Calif.: 4.4%

U.S.: 1.4%



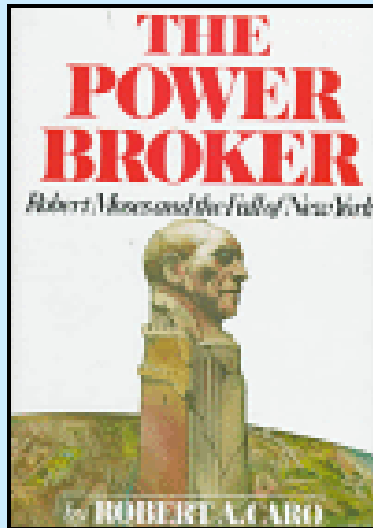
**California Population in 1940:**

**7 million**

**California Population in 1950:**

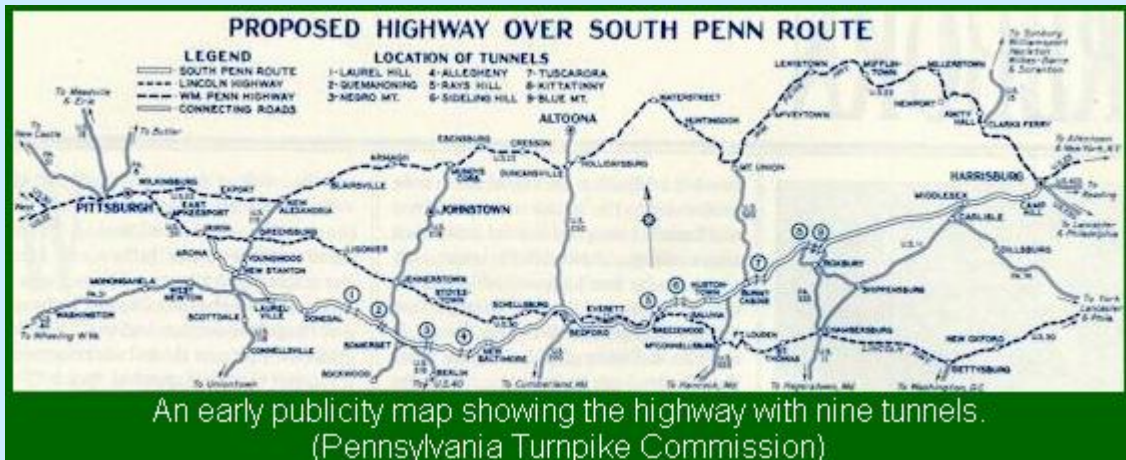
**10.6 million**

# *Robert Moses and his NYC-area Parkways*





# *Toll Roads?*



# Revenue Source: *Gas Tax*



Opposition from oil companies





# *Buses and Trucks*



Ken Goudy Collection



**Let cars pay for it.**



# *Collier-Burns Act* (1947)

- **Proposal: Put gas and other motor-vehicle related taxes into trust fund to avoid “diversion”**
- **Raise gas and related taxes to build freeways and other roads**

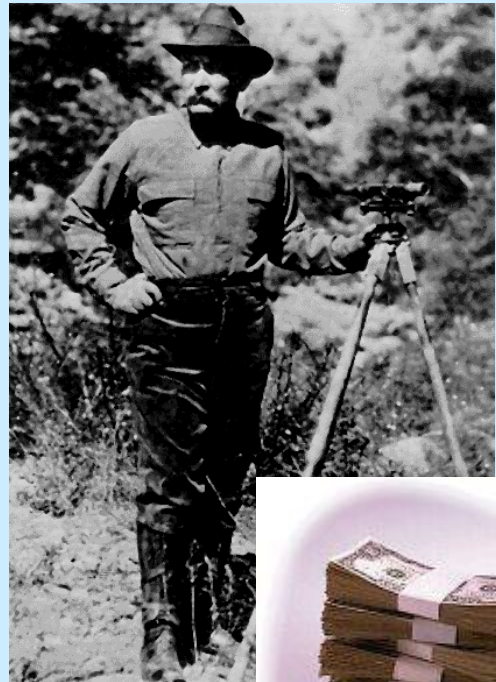


**Randolph Collier,  
“Father of the American Freeways”  
City of Yreka, CA  
Dedicated 1995**

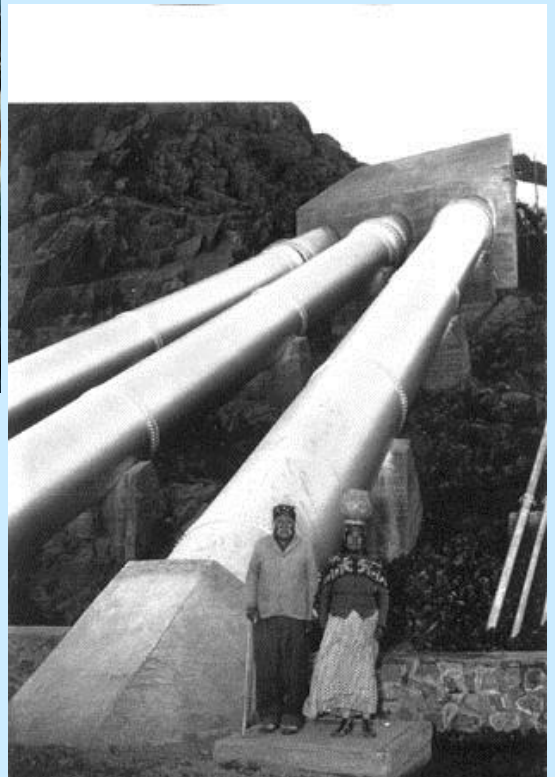




# *Owens Valley Project*



# *Colorado Water Project*



# *Master Plan for Higher Education*







# ***The California Deal***

- **Vote bonds for water projects**
  - Get water paid for in water bills
- **Pay gas and related taxes**
  - Get roads and freeways
- **Pay state taxes**
  - Get higher education
- **Pay property tax**
  - Get schools, police, fire





# *The California Deal*

- **Property taxes rise rapidly in 1970s due to rising real estate values**
  - Did schools, police, fire service improve proportionately?
  - Busing controversy in LA especially SF Valley weakens link between school and property tax payer
- **Car tax increase in 2003**
  - Were new roads, etc., going to result?





# **California's Budget Conflict:** *Lessons from the Present and the Past*



## **Lesson #1**

**The conflict is with the electorate. Thus, negotiations models are not relevant. The state can't negotiate with the electorate.**

●

# **California's Budget Conflict:** *Lessons from the Present and the Past*



## **Lesson #2**

**Voters want the old California deal. Fiddling with term limits, etc., will not resolve the conflict.**



# **California's Budget Conflict:** *Lessons from the Present and the Past*



## **Lesson #3**

**Need closer tie between taxes  
paid and services delivered.  
That implies user fees, move of  
revenue and expenditure back  
toward local govt.**

●

# **California's Budget Conflict:** *Lessons from the Present and the Past*



## **Lesson #4**

**Since deal was breached, need  
devices to renew trust. Trust  
funds, performance targets,  
perceived accountability,  
honest budgets.**



*And finally, now  
that Props 57 & 58  
were passed let's  
have...*



## **Transparency in accounting:**

- **Distinguish stocks from flows  
(deficit and debt are different)**
- **Consistent methodology from  
year to year**
- **Borrowing isn't revenue**
- **Revenues and expenditures  
can't be negative**
- **Distinguish between managerial  
accounting and bookkeeping**





# \$38 Billion



## What Does It Mean?



# \$38 Billion

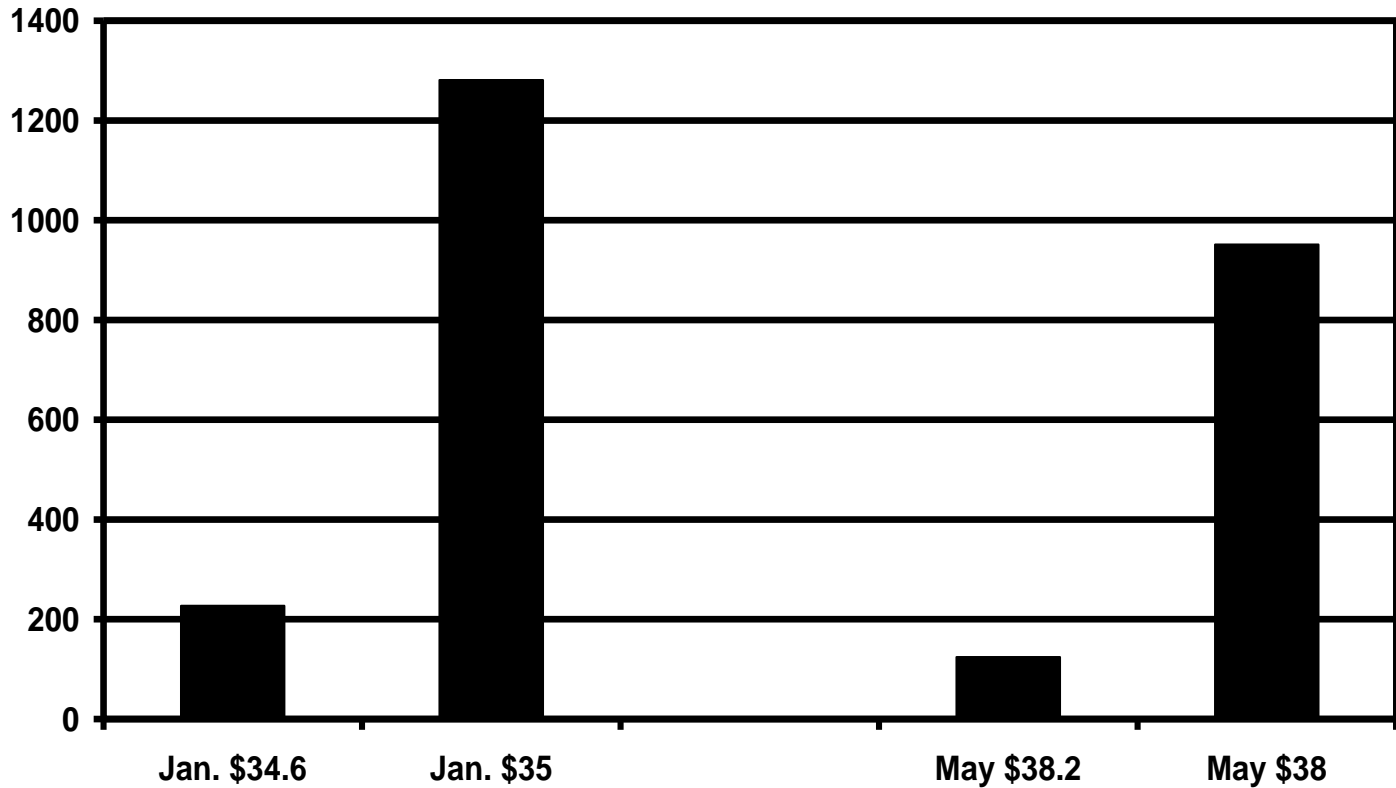


**Nexis-Lexis Citations:**

**1 Month ●**

## Number of Media Citations Within One Month of 2003 Budget Announcements for FY 2003-04

calopinion.xls  
nexislexis



Note: Citation count for all periods as of July 12, 2003.



Juggling the Numbers



FINANCIAL ACCOUNTING STANDARDS BOARD



Governmental Accounting Standards Board



THE CHRISTIAN SCIENCE MONITOR Bennett

Juggling the Numbers



# **California's Budget Conflict:** *Lessons from the Present and the Past*



**Daniel J.B. Mitchell**  
*Ho-Su Wu Professor*  
*Anderson Great Ideas*  
*Seminar*  
*April 14, 2004*